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August 1, 1996

VIA FEDERAL EXPRESS

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
Room 222
1919 M Street, NW
Washington, D.C. 20554

Re: CC Docket Number 96-45

Dear Mr. Caton:

Please find enclosed an original and four (4) copies of the Further Comments of the Maine Public Utilities Commission, Montana Public Service Commission, New Mexico State Corporation Commission, Utah Division of Public Utilities, Utah Public Service Commission, Vermont Department of Public Service, Vermont Public Service Board, and Wyoming Public Service Commission in the above docket.

I also enclose one additional copy, marked "STAMP COPY." Please date stamp this copy and return it to me in the enclosed postage-paid envelope.

Sincerely,

Peter M. Bluhm
Policy Director

Enclosure (postage-paid envelope)
cc: filing states

STAMP Copy

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
Federal-State Joint Board on	)	CC Docket No. 96-45
Universal Service	)	
	)	

COMMENTS OF:
THE STATE OF MAINE PUBLIC UTILITIES COMMISSION,
THE STATE OF MONTANA PUBLIC SERVICE COMMISSION
THE STATE OF NEW MEXICO STATE CORPORATION COMMISSION,
THE STATE OF UTAH DIVISION OF PUBLIC UTILITIES
THE STATE OF UTAH PUBLIC SERVICE COMMISSION
THE STATE OF VERMONT DEPARTMENT OF PUBLIC SERVICE
THE STATE OF VERMONT PUBLIC SERVICE BOARD; AND
THE STATE OF WYOMING PUBLIC SERVICE COMMISSION

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SUMMARY

The Telecommunications Act of 1996 imposes an extraordinary burden on the Commission, it designing a system of high cost supports. That system must ensure that rates are reasonably comparable between rural, insular and high cost areas on the one hand and urban areas on the other. This statutory goal can be met only if the Commission establishes a high cost funding mechanism that is adequately funded and that accurately targets support to high cost areas. The system should be based on reported costs of carriers, or eventually on costs developed through a proxy model. Support distributions should not be based upon rates, since rates are extremely difficult to compare accurately, although corrected rates should be used as a check on the program's effectiveness. Subscribership level should also be used as a second check on program effectiveness, as subscribership should increase among all relevant populations.

The Commission should administer assistance to schools, libraries, and health care providers through a block grant to each state. This should maximize the benefit from these discounts and will coordinate well with parallel state programs.

Several changes to the existing high cost support system are needed, at minimum, including the elimination of discrimination based on size, and the combination of loop cost, switching cost and local transport cost. Also, the Commission may need to increase substantially the size of the high cost fund, as the system should provide support when company costs in any local area exceed the average of costs in urban areas. Finally, the system should impose limitations on administrative cost. Price cap companies should remain eligible for high cost assistance.

Proxy models are improving, and show promise for use in calculating company costs. Further analysis is needed, however, before they can be used as the basis for high cost support, and that additional analysis is anticipated within the next two months.

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COMMENTS

Definitions Issues

1. Is it appropriate to assume that current rates for services included within the definition of universal service are affordable, despite variations among companies and service areas?

No, the Telecommunications Act of 1996 establishes a more ambitious standard for universal service, a standard that is more demanding than the policies that originally led to the creation of the existing high cost fund, which served as the basis for existing rates.[1] The Act requires the Commission to seek reasonably comparable rates between rural, insular, and high cost areas on the one hand and urban areas on the other.[2]

It is true that something approaching universal service has been achieved in many jurisdictions at what are considered to be affordable rates. These rates have generally been achieved through rate averaging processes. The developing competitive marketplace may require deaveraging of rates. Maintenance of affordable rates may be in serious jeopardy unless an adequate universal service fund is implemented to address deaveraged rates and costs.

As stated in earlier comments, we recommend that the Commission base universal service support on the costs of providing universal service, not upon rates. For the immediate future those costs can be reported carrier costs. Eventually, when a proxy model has gained general acceptance, costs can be predicted by that proxy model.

Unadjusted rate levels cannot be used as a means for distributing high cost support. However, the following points must be considered even if aggregate rate levels are used as a check on the success of the universal service program.

It would not be appropriate to assume that current rates charged for universal service are affordable in all parts of the country. The statutory goal of reasonably comparable rates requires the Commission to undertake actual research to measure the rates charged to customers for universal service and to correct for certain measurement problems.

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[1] For example, the inadequacy of the existing fund which penalizes study areas with more than 200,000 lines has led to fairly high local rates in both Vermont and West Virginia, and therefore it should not be deemed that such rates comply with the act.

[2] Telecommunications Act of 1996, § 214(b)(3).

Formidable measurement problems must be overcome before any conclusion is possible that rates for universal service in a particular area are high or low. High local rates can be the result of state policy decisions. These include:

- large local calling areas;
- low reliance on per-minute charges for local service;
- low reliance on intrastate toll as a source of revenue;
- small differentials between residential and business line rates; and
- inclusion of touch tone in basic service charges.

It is important to recognize that state commissions in many high cost states have preserved the affordability of local residential exchange through a variety of measures, including defining small local calling areas, increasing local measured service charges, high intraLATA toll and access rates, high business dial tone rates, and separately stating touch tone charges. These policies have produced a basic service rate that obscures the added costs paid by customers in other ways.[3]

Thus one state may have apparently high rates as the result of policy choices; yet another state's apparently high rates may be an accurate reflection of a heavy consumer burden. Although the measurement task will be difficult, it is essential that the Commission establish a system that measures rates for universal service and then corrects the raw data to compensate for the effects of local policy choices.

After corrections are made for these local policy factors, it is highly unlikely that current rates in all parts of the country will be found to be equally affordable. Several factors now affect affordability.

- Some areas lack the economic opportunities present in other areas. For example, a state without a major metropolitan area will be more likely to have high overall rates; the paucity of low-cost customers will keep average rates high.
- Some rural areas served by companies with small study areas receive substantial universal service support. Rates for these companies can be

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[3] The comparison of rates should also consider the size of the Subscriber Line Charge. Many urban residential customers pay less than the $3.50 maximum SLC.

expected to be comparatively low. Other companies, however, may serve areas with virtually identical costs, but are deprived of substantial assistance because the area the serve contains more than 200,000 lines. Customers in these areas can expect to pay substantially higher rates.

It is important to define clearly the purpose to be served by measuring universal service rates. It is not necessary to measure universal service rates in order to calculate financial support to high cost areas. Even corrected data on rates would be inherently too imprecise to provide an adequate basis for a support calculation. Moreover, basing support upon rates could distort the normal financial behavior of carriers.

Rather, the Commission should measure the rates charged for the set of services included within "universal service" as a means of measuring the effectiveness of its universal service program. Since "reasonably comparable" rates between urban and rural areas is a major statutory goal of the Act,[4] it is important to collect data on whether that criterion has been met. The Commission will not be able to determine whether its universal service programs have succeeded or failed unless it collects and reports this data.

2. To what extent should non-rate factors, such as subscribership level, telephone expenditures as a percentage of income, cost of living, or local calling area size be considered in determining the affordability and reasonable comparability of rates?

Yes, there are ways that non-rate factors should be considered. The Commission should continue to monitor subscribership levels as an indicator of the success of its programs. If the Commission's efforts to preserve universal service are successful, subscribership should not be found to decline, but should stay stable or increase. This success should be apparent when measured in several ways:

- aggregate penetration at the national level should remain stable or improve;
- aggregate penetration in each geographic region of the country should remain stable and, in areas that are below the current average national penetration rate, should improve;

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[4] Telecommunications Act of 1996, § 254(b)(3).

- penetration in rural, insular and high cost areas should remain stable or improve; and
- penetration within each income class should remain stable or improve.

3. When making the "affordability" determination required by section 254(i) of the Act, what are the advantages and disadvantages of using a specific national benchmark rate for core services in a proxy model?

Section 254(i) requires the Commission and the states to ensure that universal service is available at rates that are just, reasonable, and affordable.

The Commenting States are not clear about the nature of this question. The latter part of the question seems to presuppose that a proxy model requires a "benchmark rate for core services." Our understanding of proxy models, however, is that they calculate carrier costs per line based upon independent criteria such as customer density, location of existing facilities, and terrain slope. We understand that the proxy models do not use rates as an input nor do they predict rates as an output.[5]

As stated in earlier comments, we recommend that the Commission base universal service support on the costs of providing universal service, not upon rates. For the immediate future those costs can be reported carrier costs. Eventually, when a proxy model has gained general acceptance, costs can be predicted by that proxy model.

We recommended above that the Commission measure consumer rates and correct for state and local policy differences that affect those rates. Such a program evaluation system would be an adequate basis to implement subsection 254(i). The statute does not require that the Commission distribute universal service support through a system that uses rates as an input; rates can be used as a check on the health of the universal service support system.

The question remaining is what benchmark should be used to determine when rates are "affordable" under subsection 254(i). It is worth noting that Section 254(c)(3) of the Act establishes the goal that rates be "reasonably comparable" between urban

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[5] The proxy models do predict cost, and cost in a competitive environment can be presumed to be predictive of rates.

areas and rural, insular and high cost areas. The Commission should use this standard in interpreting section 254(i) as well. Universal service programs will be successful under both statutory standards if they reduce rates in rural, insular, and high cost areas to rates approximately equal to those charged for universal services in urban areas.

The use of the urban average rate, while probably lower than the national average rate, will not in itself be adequate to protect universal service. Data developed by the Commission show that household income is a strong predictor of telephone penetration. Among the lowest income households, even urban rates for telephone service and the Lifeline and Link-Up programs are not sufficient to keep subscribership levels at the levels experienced by more affluent customers. Therefore additional income-sensitive programs are needed such as Lifeline and Link-up.

5. A number of commenters proposed various services to be included on the list of supported services, including access to directory assistance, emergency assistance, and advanced services. Although the delivery of these services may require a local loop, do loop costs accurately represent the actual cost of providing core services? To the extent that loop costs do not fully represent the costs associated with including a service in the definition of core services, identify and quantify other costs to be considered.

While the local loop may be a major cost in providing universal service, it is not the only cost that should be considered. Loop costs, by themselves, neither accurately nor sufficiently represent the full cost of providing core services. The list of core services proposed by many commenting parties to be considered universal, often involve costs which go well beyond the costs of the local loop alone. This is especially true since we expect the definition of core services to evolve and expand over time.

The Commission should recognize that numerous additional functionalities are necessary to provide universal services. Even basic services such as the ability to interconnect with the interexchange network require switches and trunks at the local wire center. The Commission's model for universal support should fully recognize all of the elements or functionalities necessary to provide each element contained in the definition of universal service. In the case of many such services, this will include not

only loop, but also switching, local transport and interconnection to the public switched network.

It is also noteworthy that the larger the set of services that the Commission determines to be eligible for universal service support, the greater will be the likely cost of the support system. The Commission should not establish an upper limit for the amount of universal service support available nationally. However, if for some reason the Commission should happen to entertain a practical upper limit for the amount of universal service support available nationally, it should be cautious when defining the list of services eligible for universal service support.

It is also worth noting that the inclusion of a service as eligible for universal service support should not imply that the absence of that service makes the area served ineligible for universal service support. For example, while Enhanced 911 may be eligible for support, it is not available everywhere, and its absence should not disqualify an area from receiving universal service support. Indeed, the Commission may want to separately identify that limited set of services that constitutes an irreducible minimum for receipt of universal service support. The Commission should distinguish between services that must be provided to establish eligibility for support and additional services that will receive support if offered.

Schools, Libraries, Health Care Providers

6. Should the services or functionalities eligible for discounts be specifically limited and identified, or should the discount apply to all available services?

School, library and health center discounts should apply to all available services. Constraints will substantially increase the administrative costs of the programs, and could suppress innovative applications for the telecommunications system by schools, libraries and health care providers.

7. Does Section 254(h) contemplate that inside wiring or other internal connections to classrooms may be eligible for universal service support of telecommunications services

provided to schools and libraries? If so, what is the estimated cost of the inside wiring and other internal connections?

Inside wiring, internal connections to classrooms and other services within schools, libraries and health care facilities, should be eligible for universal service support to the extent such services are desirable.

More generally, the Commission should refrain from establishing a tradeoff between schools, libraries and health centers on the one hand, and rural, insular, and high cost areas on the other hand. As a matter of law, the "reasonably comparable" standard must be attained, and is therefore not conditioned upon, providing adequate funding for school, library and hospital assistance programs.

However, if the Commission should happen to entertain an idea of a practical upper limit for all section 254 programs, it should be cautious in expanding the list of school, library, and health care services eligible for discounts and universal service support.

12. Should discounts be directed to the states in the form of block grants?

Yes. Block grants to the states would be an excellent and efficient way to disburse discounts to schools, libraries and health care providers. States, through their state utility regulatory commissions (or other state agencies), are easily best situated to administer the discounts, to apply needed local expertise and to provide the resources necessary to make this (or any) disbursement system work effectively. There are many advantages to be derived from allowing the states to participate actively in this discount program.[6] States offer the most accurate and efficient method to ensure that the discounts are properly applied as the Act requires. Efficient coordination and accurate disbursement to targeted areas of need require the resources which only the states can bring to bear on the challenge.

Section 254 of the Act envisions both federal and state mechanisms to provide discounts to schools, libraries and health centers. By giving funds to the states in the form of block grants, the Commission would be encouraging the maximum possible

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[6] See, Wyoming Public Service Commission's Reply Comments at paragraph 4(b).

coordination between these two mechanisms. The act stresses a partnership of the federal and state jurisdictions, and block grants would be another practical way to implement partnership with the states.

Block grants will give states the opportunity to focus support in areas that have the greatest need and that can use the support to greatest advantage. Decisions about where funds can best be spent will be most effectively made by state officials who have the expertise and human resources to advise schools, libraries and hospitals on the most effective use of available services. State officials best understand the context in which the benefits will be distributed and can best manage delivery of support to achieve the maximum impact. Given their small staffs and funding limitations, many schools and libraries today welcome the advice from state agencies who today already provide a mixture of advice and financial support.

Block grants also may produce more innovative uses of the telecommunications network. For instance, block grants could have the effect of encouraging joint action among schools, libraries and health care facilities who otherwise might act alone. If these joint projects were to develop, either spontaneously or with state encouragement, the network could be used more efficiently. Also, states receiving block grants might be able to aggregate demand and thereby obtain greater buying power.

Block grants also would simplify matters for consumers. Under other systems, a consumer who just received a bill might need to know whether a particular service is in the interstate or intrastate jurisdiction before he or she an determine whether the bill grants appropriate discounts. Calls from a school to certain online services might be interstate calls, for example, and subject to discounts established by the Commission. From the same telephone, however, calls to the local university would probably be an intrastate service, and will be subject to discounts set by state commissions. This parallel discounting arrangement is bound to be confusing and frustrating to consumers.

Finally, the total amount of funding passing through the program can be more easily controlled at the federal level. This may become an important consideration as tens of thousands of schools and libraries across the nation begin to explore the possibilities arising from greater access to information. It is also possible that block

grants would reduce administrative cost. While it may be necessary to give states some small amount of funds to administer grants, the block grant system would allow the Commission to avoid unnecessary administrative complications that would be inherent in a system of direct distribution of federal support to many claimants.

13. Should discounts for schools, libraries, and health care providers take the form of direct billing credits for telecommunications services provided to eligible institutions?

Maximum flexibility should be afforded to the states to administer the block grants.

14. If the discounts are disbursed as block grants to states or as direct billing credits for schools, libraries, and health care providers, what, if any, measures should be implemented to assure that the funds allocated for discounts are used for their intended purposes?

To provide the necessary fairness and uniformity, the Act itself establishes sufficient procedures and guidelines for state implementation of block grants. Individual states should be able to develop specific plans for administering discounts. In conclusion, as long as states adhere to the statutory guidelines, there will be good assurance that the discounts are being utilized for their intended purposes.

High Cost Fund

26. If the existing high-cost support mechanism remains in place (on either a permanent or temporary basis), what modifications, if any, are required to comply with the Telecommunications Act of 1996?

The Telecommunications Act of 1996 establishes an ambitious standard for universal service, a standard that is more demanding than the policies that originally led to the creation of the existing high cost fund. The Act requires the Commission to seek reasonably comparable rates between rural, insular, and high cost areas on the one hand

and urban areas on the other.[7] To achieve this objective, the Commission must be prepared at the very least to make substantial revisions to the size of the high-cost fund and also to the mechanism by which it operates.

Before discussing needed modifications, however, it is important to note that the fundamental unit of the present high cost support system is the "study area," roughly defined as the contiguous service territory of the traditional local exchange carrier. Of primary importance in designing a new system is the recognition that the concept of "study area" will lose vitality under the kind of local exchange competition envisioned by the Act.

Study areas were initially designed in the context of a specific industry configuration. An essential element at that time was that local exchange services were provided to well-defined franchise areas by monopoly providers.

A principal purpose of the Telecommunications Act of 1996 is to establish local exchange competition. Once such competition has become well established, the franchise boundaries of the traditional carrier will have little relevance to service affordability. State commissions may permit competing carriers to offer service over areas that differ greatly in size, shape and economic characteristics from the characteristics of traditional franchised local exchange carriers. If carrier A has a 40 percent market share and carriers B and C each have a 25 percent market share, it is difficult to see why high-cost assistance should be based upon the cost characteristics of Company A, even if Company A was historically the original local exchange carrier before passage of the Act.

In addition, when study areas were created, it was also assumed that ratepayers within a study area all paid the same rates. Therefore the entire company service area was the relevant scale to measure costs.

Under competition, however, rate designs can no longer be assumed to be uniform throughout a carrier's territory. Competition will put pressure on traditional carriers to decrease rates in competitive low-cost areas. In some states these companies may be

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[7] Telecommunications Act of 1996, § 214(b)(3).

permitted to reduce rates in low cost urban and suburban areas and to increase costs elsewhere.

In summary, both premises underlying the concept of "study area" will become increasingly irrelevant as the policy objectives of the Telecommunications Act of 1996 are achieved. This is one of many reasons why the development of cost proxy models, which are based upon analysis of different geographic units, is a promising development.

Nevertheless, the Common Carrier Bureau, on behalf of the staff of the Federal-State Joint Board, has asked what changes would be needed if the existing high-cost system were to be retained, even temporarily.

Five changes are needed:

- Discrimination based solely upon the number of subscribers in the carrier's study area should be eliminated.
- Switching cost should be included in the high cost program, and the DEM weighting program should be eliminated.
- Local transport cost should be included in the high cost program.
- The system should use urban costs, rather than national average costs, as the benchmark against which to determine excessive cost.
- Administrative costs should be limited or capped.

26.1 Size Discrimination

The current high cost fund reduces assistance to companies with more than 200,000 subscriber lines ("large study areas").[8] This distinction should be eliminated.

The discrimination against large study areas may have been at somewhat rational at one time. Certainly many large study areas contain a significant numbers of customers living in densely populated areas with low loop costs and low switching costs.[9] Because all or nearly all local exchange rates today are based upon company-

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[8] Size discrimination in support for switching cost is discussed in the next section.

[9] It is also true that many densely populated areas also have a high proportion of business lines who pay significantly higher rates, but who do not impose significantly

wide averaging, customers in a large study area's low-cost regions can generate contributions for the benefit of high-cost regions. Where such internal contributions are available, it may have been rational to use such contributions to reduce the amount of funding needed for the high cost fund.

However, even under the present system the use of these internal transfers is not fair to all large study areas. Not all large study areas are equally capable of creating internal contributions In Vermont, for example, NYNEX has more than 200,000 access lines, but does not serve any large metropolitan area. Even after the internal contributions are considered, average loop costs in Vermont and several other large study areas are still substantially higher than the national average. This shows that in Vermont, as is also true in some other predominantly rural states, the opportunity to obtain contribution from urban and business customers is seriously limited. The Commission should not rely on a method of supporting universal service that only works in some parts of the country.

The Telecommunications Act of 1996 fundamentally changes the appropriateness of the present system. What was once merely unfair has now become contrary to law. Under the clear language in the Telecommunications Act of 1996, the Commission must replace internal cross-subsidies with explicit mechanisms to support universal service.[10] This is added reason not to perpetuate the 200,000 lines distinction.

Elimination of the 200,000 lines distinction is also essential from an economic viewpoint. A fundamental purpose of the Telecommunications Act of 1996 is to establish local exchange competition. One of the characteristics of a competitive market is that all providers of a service provide the service at a price based upon their own cost. To the extent that companies serving large study areas come under competitive pressure, they will seek to reduce charges imposed in low-cost areas. State commissions may balk at such rate reductions, however, if carriers must derive surplus

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higher cost.

[10] Section 254 of the Telecommunications Act of 1996 requires that any mechanisms used by the Commission to support universal service must be explicit. Telecommunications Act of 1996, § 254(e).

revenue from low-cost areas so as to support universal service in high-cost areas. This could harm the development of competition, contrary to the purposes of the Act.

In summary, elimination of the 200,000 line distinction is an essential prerequisite to ensuring that competition, and competitive price structures, develop in all parts of the country. On the other hand, continuation of the 200,000 line distinction would maintain dependence on internal transfers to support universal service, a policy that would retard competition and thus frustrate the intent of the Act.

26.2 DEM Weighting

Currently, support for high loop costs and high switching costs are determined separately. Thus, a company having high loop costs but low switching costs will receive assistance. Likewise, a company with high switching costs but low loop costs will receive assistance. Unless both loop and switching costs are high, however, the company may be able to offer universal service at reasonable rates. A reasonable interim solution to this problem is to combine loop and switching costs into a single high cost factor, and then to provide support for the combined cost using something like the existing formula for loop cost of small study areas.

Another reason to modify the existing DEM weighting system is that, like the support for loop costs, it is arbitrarily based upon company size. While it is true that small switches can be more expensive to maintain per customer, it is not true that only small companies have small switches. Small switches can reasonably be installed to serve small service territories, but they are also a reasonable engineering response to a dispersed population in a rural area. It is not sound policy to provide support for added costs arising upon the former problem but not the latter.

In other words, universal service studies can be applied more effectively if it is targeted using reported costs, rather than on the basis of a proxy factor, like company size, that only partially correlates with high cost. Furthermore, the service territories of new facilities-based local competitors may bear little relationship to existing study areas, and scarce universal service support dollars could be wasted if subsidies were directed to an inefficient service provider when a more larger and efficient provider is in the same market.

26.3 Transport Costs

Transport costs are the cost of connecting an exchange to the public switched network, at the first tandem. In addition to considering loop and switching costs on a combined basis, transport costs must also be included in high cost assistance formula. These costs may comprise a large portion of a company's local exchange service revenue requirement, and they must be supported by the Commission's universal service mechanisms if the statutory criterion of rate comparability is to be achieved. This is particularly important for areas that are islands or remote territories where a large portion of the local costs are for transport.

26.4 Urban Costs

The Commission should change the standard against which costs are measured and the support given to companies above average cost.

One essential change from the present system is to replace the use of national average loop cost data with urban average loop cost data. Currently, the high cost fund measures loop cost by comparison to nationwide average costs. The size of the serving company is used as a proxy for high switching costs. Both of those support mechanisms will need to be replaced with a mechanism that uses both switching costs and loop costs on a combined basis in urban areas as the benchmark for determining the level of high cost assistance for rural areas.

A second needed change is to recognize that comparable rates will not be available in high cost areas unless the Commission undertakes to provide support for all costs above the benchmark urban cost level. Ideally, the Commission would provide high cost support for 100% of all costs that exceed the urban standard. Only a measure such as this will have a reasonable chance to achieve the objectives of the Act.

26.5 Administrative Costs

Some companies today may be obtaining excessive benefits from the high cost fund by loading up on loop costs with Administrative and General expenses. Indeed, this expense category may be a haven for the most significant present abuse of the High

Cost Fund. Administrative costs should be limited. One mechanism to limit them would be to establish a benchmark based on company size. In the alternative, a capping mechanism could be used to limit recognition of administrative cost for those companies with extraordinarily high reported administrative cost per line.

27. If the high-cost support system is kept in place for rural areas, how should it be modified to target the fund better and consistently with the Telecommunications Act of 1996?

As stated in answer 26 above, the high cost support system must be modified to include the factors that truly contribute to high cost. That is, it should respond to the combination of switching, loop, and transport costs. Universal service funding should only be given if a company's total costs are high, and not merely if one factor indicates high cost but the company's overall costs are low. Therefore, assistance to small companies currently getting high cost assistance due to DEM weighting but which have low cost in general, should not be provided assistance.

Also as stated above, the system should disregard factors, like study area size or company size, that do not bear directly on cost.

28. What are the potential advantages and disadvantages of basing the payments to competitive carriers on the book costs of the incumbent local exchange carrier operating in the same service area?

The Commission should adopt a system under which high cost support is based upon either the reported costs of incumbent carriers or the costs predicted by a proxy model. Payments should be available both to traditional carriers and to competing service providers who provide at least the minimum services required for universal service. This would promote competition by allowing an entrant to provide the same service at lower cost and yet receive the same support.

New service providers will not generally be required, nor will they choose, to maintain financial accounts in the same format as existing carriers.[11] Their reported costs therefore probably cannot be used reliably as the basis for universal service assistance.

In the short run, reported costs should be more reliable than the results of nascent proxy models. Therefore, book costs should be used as an interim measure until proxy models are acceptably accurate.

If the Commission is concerned about the opportunity for abuse, or the lack of incentives for efficient management by support recipients, one option would be to cap reported costs at their existing levels within each study area. Also, if book cost is verifiable and is lower than proxy cost, the Commission could use the lower and thereby somewhat reduce the size of the fund. This could apply where plant is close to being fully depreciated.

29. Should price cap companies be eligible for high-cost support, and if not, how would the exclusion of price cap carriers be consistent with the provisions of section 214(e) of the Communications Act? In the alternative, should high-cost support be structured differently for price cap carriers than for other carriers?

Price cap companies should receive high-cost support because the method of regulating the company's rates is essentially irrelevant to its need for assistance in maintaining reasonably comparable rates. To understand this conclusion, it is important to examine both possible definitions of "price cap company." In either case, however, price cap companies should remain eligible for high cost support.

The simpler case is that of a company subject to FCC price caps for its interstate operations, but subject to a traditional form of regulation within its state jurisdiction. Unless the company receives high-cost assistance, its interstate allocation of non-traffic sensitive costs is 25 percent, and its intrastate allocation is 75 percent. Thus three-quarters of the company's loop cost must be recovered through rates set by the state

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[11] Furthermore, the traditional cost of service review afforded by state commissions will not likely be applied to the accounts of new local service providers.

commission. If those loop costs are high, it may be impossible for the company, without assistance from the Commission, to maintain reasonably comparable rates with urban areas. This is true equally if the company is subject to price caps. If price caps were to be considered at all, it would necessarily be a relatively minor factor when stood beside the weightier fact that loop costs are a primary driver in determining consumer rates. It would violate the Telecommunications Act of 1996 to conclude that the company's ratepayers must be deprived of reasonably comparable rates simply because one-quarter of the company's loop cost is recovered under a price cap regime.

There may be ways for the Commission to adjust its price caps plans to reflect the introduction of high cost support. One course would be to freeze the costs reported by price cap LEC's at present levels and apply an annual productivity adjustment. In essence, this would impute productivity gains when computing the need for high cost assistance.

The second possible meaning of "price caps" is a company under price caps regulation at both the federal and state level. This case is distinguishable from the first case only in that a state commission typically will have established a plan to adjust the company's rates from time to time based upon such factors as rates of inflation and industry productivity gains. No different conclusion is required, however, as any increase in high cost support experienced by a company subject to state price caps should be able to lead to a rate adjustment by the state commissions under the price cap plan.[12]

It should also be noted that if the Commission were to declare companies subject to state price caps plans to be ineligible for high cost assistance, it might produce perverse effects. The Act encourages states to implement alternative forms of regulation, including price caps. To exclude price cap companies from eligibility for high cost assistance would have the perverse effect of discouraging the form of regulation the Act encourages.

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[12] Many state price cap plans expressly provide for rate adjustments following changes in high cost assistance levels.

Finally, it should be emphasized that, even in states using price caps for intrastate rates, the book cost revenue requirement of the company is used to set the baseline revenue requirement on which the price cap plan then proceeds. Therefore, high cost support must be provided for those companies serving high cost areas in order to comply with section 214 of the Act because even under price cap regulation their revenue needs will be higher than the national average.

If for some reason the Commission rejects these arguments and does not allow price cap companies to receive high cost support, it should create an option for price cap companies. A company serving a high cost study area must have access to high cost support, or its rates will not be comparable to those in urban areas. Such companies should be able to opt out of price caps, for that study area, in order to get access to high cost funds, and thereby comply with Section 214 of the Act.

31. If a bifurcated plan that would allow the use of book costs (instead of proxy costs) were used for rural companies, how should rural companies be defined?

The Commission should use the definition of rural company as found in Sec. 3 of the Communications Act of 1934, as amended (47 U.S.C. § 153(37)). This four-part alternative definition is broadly inclusive.

32. If such a bifurcated approach is used, should those carriers initially allowed to use book costs eventually transition to a proxy system or a system of competitive bidding? If these companies are transitioned from book costs, how long should the transition be? What would be the basis for high-cost assistance to competitors under a bifurcated approach, both initially and during a transition period?

No company should receive high cost support based upon the proxy models until those models have become generally accepted. Small companies, many of which would fit the definition of "rural," and their subscribers are, perhaps, more vulnerable to the effects of a proxy model for two reasons. First, absent any systematic bias, any inaccuracy in cost prediction can be "averaged out" for a larger company, but this is less likely for a small company. If a proxy system is used for small, rural companies,

some exception or waiver mechanism may be appropriate where the proxy model is demonstrated to predict cost poorly.

Second, the revenue requirement of a small LEC may be highly dependent on the life cycle of their switches and other major capital additions, and such investments tend to occur in a nonlinear fashion. While a proxy model may accurately predict the levelized costs of a small LEC, reported costs more closely reflect the actual purchase of capital assets.

A phased transition from reported costs to proxy costs, or from the present level of High Cost Assistance to the new universal service assistance, would promote the public interest because a rapid transition may cause either rate shock to consumers or financial instability of companies. This could, in turn, impair carriers' ability to provide reliable service and invest in network modernization. A transitional schedule such as that applied to the Subscriber Plant Factor ("SPF") would be reasonable.

Even if a proxy model is found to operate properly in general, it may not work in every case, particularly for smaller companies. The Commission should establish a waiver process for extraordinary circumstances for small companies. A petitioner should be able to get additional high cost support if it can show extraordinary circumstances that are not appropriate for inclusion in the proxy model.

When a proxy model gains general acceptance, bifurcation is a reasonable transitional measure. A five year transition would be appropriate at that point.

33. If a proxy model is used, should carriers serving areas with subscription below a certain level continue to receive assistance at levels currently produced under the HCF and DEM weighting subsidies?

In areas where subscription rates are significantly below the national average, the Commission probably should not reduce support and thereby induce higher rates. It may be appropriate to allow for this problem through waiver requests.

If the Commission follows the suggested course of establishing a policy of maintaining current assistance, that policy should provide support that is the greater of existing support and the new high cost support.

This policy might be advisable if high basic exchange rates, despite the availability of Lifeline and Link-up credits, are determined to contribute significantly to low phone penetration. Some observers have found that the low income residents of the District of Columbia have among the lowest penetration rates, despite the availability of three dollar per month basic service, this fact demonstrates that low rates are only a partial solution. Because income levels of subscribers within study areas or even census block groups may vary significantly, enhancing the benefits provided under the Lifeline, Link-up or other programs may be a more cost-effective means to increase subscriber levels.

Proxy Models

34. What, if any, programs (in addition to those aimed at high cost areas) are needed to ensure that insular areas have affordable telecommunications service?

The proxy models should be modified to include a factor which will account for the high cost of connecting a class 5 switch in a remote area to the public switched network. This could include an add-on factor for transport and an add on-factor to the overall costs to account for the fact that hauling goods for maintenance and bringing service personnel to islands and remote areas is relatively high compared to those areas which are connected to the mainland. In addition, this increased payment for islands should also be made available to those areas which are not on actually islands but are not connected by road to the rest of the nation, such as bush communities in rural Alaska.

36. What proposals, if any, have been considered by interested parties to harmonize the differences between the various proxy cost proposals? What results have been achieved?

The Maine Public Utilities Commission staff has been analyzing all three models presently submitted to the FCC and is trying the synthesize the best aspects of each model into a recommended proposal for use in this docket. The Maine staff expects that a document incorporating these recommendations will be available in early